

# A Post-2015 Development Agenda: What Role for ODA?

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In 2005, at the Gleneagles G8 meeting, OECD donors committed themselves to substantially scaling up their aid to low-income countries as a means to boost financing for the Millennium Development Goals (MDGs). However, Official Development Assistance (ODA) to these countries has remained low relative to their Gross National Incomes (GNI) and has continued to be volatile and unreliable. This Development Viewpoint offers some suggestions on how the role of ODA could be strengthened for a post-2015 development agenda (see Martins 2010).

Table 1 shows how ODA to low-income countries declined from 7.9% of the recipients' GNI during 2000-04 to 7.7% during 2005-08 – after having risen from 7.2% in 1995-99. This share had been significantly higher during 1990-94, at 9.8%.

How have low-income countries fared relative to middle-income countries? Between 2000-04 and 2005-08, the share of ODA going to low-income countries, as compared to middle-income countries, dropped from 43.7% to 39.4%. In other words, a little over 60% of ODA was still directed to middle-income countries during 2005-08. This was only slightly lower than the figure for 1990-94, namely, 63%.

Hence, from the perspective of low-income countries themselves, donors have not followed through on their pledge to finance a 'big-push' to achieve the MDGs. In fact, relative to the size of their own economies and relative to middle-income countries, they have witnessed a reduction.

**Table 1: Foreign Aid to Developing Countries (Period Averages)**

	1990-1994	1995-1999	2000-2004	2005-2008
<b>ODA (% GNI)</b>				
Low income	9.8	7.2	7.9	7.7
Middle income	0.8	0.5	0.4	0.4
<b>ODA (% Group Total)</b>				
Low income	37.0	38.3	43.7	39.4
Middle income	63.0	61.7	56.3	60.6

Source: World Bank (2010). World Development Indicators, <http://data.worldbank.org/data-catalog>

In addition, ODA has not proven to be a reliable source of financing. Table 2 reports trends in the 'coefficient of variation', a measure of deviations from an average value. When the coefficient is larger, there is more volatility in the variable being measured.

Note that the coefficient for ODA flowing to low-income countries rose from 4.7% during 1990-94 to 11.5% during 1995-99, and then to 27.1%

in 2000-04. Despite declining in recent years, this coefficient remained at 18.4%, a historically high level.

In middle-income countries, there has been a steady rise in volatility, with the coefficient of variation rising from a low of 4.5% during 1990-94 to a high of 12.9% during 2005-08. Therefore, for both low-income and middle-income developing countries, aid volatility has been a significant, if not intensifying, problem.

**Table 2: The Volatility of ODA (Coefficient of Variation, %)**

	1990-1994	1995-1999	2000-2004	2005-2008
Low income	4.7	11.5	27.1	18.4
Middle income	4.5	8.5	12.9	12.9

Source: World Bank (2010). World Development Indicators, <http://data.worldbank.org/data-catalog>

Even if ODA flows are raised in the medium-term, an increase in their volatility (year-on-year variation) could undermine their effectiveness. This problem is aggravated when aid is unpredictable - i.e. commitments are poor predictors of actual disbursements. Aid shortfalls will often lead to delays in the implementation of development projects and therefore to compensating increases in domestic financing.

An additional problem is that aid inflows into a recipient country tend to increase when its growth is rising but decline when it is falling—that is, aid is pro-cyclical. This is precisely the opposite of the optimal pattern in accordance with country need.

## Macroeconomic Framework

Hence, while foreign aid inflows can provide valuable finance for recipient countries, their magnitude and disbursement patterns can create significant problems. Examining the recent role of ODA in promoting the MDGs in low-income countries can offer useful clues on how to craft a more development-oriented post-2015 MDG agenda.

Critical to this effort would be a supportive macroeconomic framework, which would allow governments and central banks to utilise ODA effectively. Such a framework should be geared to promoting long-term growth and development, not short-term macroeconomic stability supplemented by poverty alleviation. Donors should adopt a similarly long-term approach in their disbursement of ODA.

In such an approach, the focus of fiscal policy would be on substantially scaling up public investment programmes in economic and social infrastructure. Monetary policy would play a secondary but complementary role of accommodating the fiscal expansion through encouraging domestic credit and maintaining low real rates of interest.

But this policy stance would be incompatible with restrictive inflation targeting.

Aid inflows should concentrate on financing the scaling up of public investment since it is likely to generate significant multiplier effects in the economy as well as accelerate poverty reduction. Public investment would 'crowd-in' private sector investment through lowering business costs (e.g., for transportation) and improving skills (e.g., through vocational training). Such active fiscal policies would reduce supply-side constraints, which are common in underdeveloped economies, as well as stimulate higher aggregate demand.

### **Aid Commitments**

In line with this focus, donors should provide aid commitments with longer time horizons and anchor their commitments in the recipient country's long-term development strategy. This would enhance a country's macroeconomic conditions since central banks could reduce their current excessive build-up of international reserves.

Such a build-up has been designed to help the central bank hedge against volatility in the real exchange rate, which can sometimes be exacerbated by aid volatility itself. Firmer aid commitments would also reduce the need of governments to resort to expensive domestic borrowing and enable them to foster a better allocation of resources between capital and recurrent spending.

Responding to the problem of aid volatility, some concrete proposals have recently been made on how ODA could help smooth and sustain domestic expenditures. One of these is the proposal for a 'foreign reserve buffer', which uses aid essentially as an insurance mechanism. Under such an arrangement, an aid windfall could be used partly to increase the aid buffer, which would then be deployed during aid shortfalls, when foreign assistance was most needed.

Another promising idea is the indexing of aid disbursements to external shocks, such as terms of trade shocks. This mechanism would automatically trigger counter-cyclical aid inflows when they were most

needed, such as providing vital foreign exchange when export receipts and foreign investment were down, and stimulating aggregate demand in economic downturns when domestic revenues were low.

The success of such initiatives would still have to rely on the strength of a country's macroeconomic policies. For example, some management of the exchange rate and capital flows would be necessary, in addition to revamping fiscal and monetary policies.

Managing the exchange rate, instead of leaving it fully flexible (and volatile), would be consistent with a development strategy that relies on accessing large inflows of foreign resources. Under a managed regime, the central bank would intervene in currency markets when capital inflows (and outflows) are sizeable and unstable. Such a regime could effectively absorb aid inflows without precipitating inflationary pressures and associated interest rate hikes.

At the same time, there would be some need to manage the capital account, particularly in resource-rich economies. One such proposal is a system of foreign exchange permits, which would manage the sale of foreign exchange to the domestic private sector. This system could steer foreign exchange towards the importing of capital goods (for example, machinery and equipment), which could enhance a country's productivity. It could also help slow the recurrent outflow of private capital from low-income countries.

This Development Viewpoint has highlighted recent problems in the declining relative magnitude of ODA and its increasing volatility, which have hindered achievement of the MDG agenda. In response, it has offered some recommendations on how low-income countries could modify their macroeconomic policies to sustain an effective post-2015 development agenda and how donors could institute policies and mechanisms to actively support such an orientation.

### **Reference:**

Martins, P. (2010). 'The Macroeconomic Management of Foreign Resource Inflows: Accelerating the Achievement of the MDGs.' UNDP Working Paper, *forthcoming*.